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No. 92-1726

In the Supreme Court of the United States

OCTOBER TERM, 1993

ENRON OIL & GAS COMPANY, PETITIONER

v.

BRUCE BABBITT, SECRETARY OF THE INTERIOR, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE FEDERAL RESPONDENTS IN OPPOSITION

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QUESTION PRESENTED

Petitioner holds mineral leases from the United States and must pay a royalty of 12 1/2 percent "in amount or value of the production removed or sold from the lease," 30 U.S.C. 226(b), calculated as "the gross proceeds accruing to the lessee from the sale thereof," 30 C.F.R. 206.103 (1987). The Department of the Interior's regulations further provide that "gross proceeds" include payments made by purchasers to reimburse the lessee for state taxes paid by the lessee. The question presented is:

Whether the court of appeals correctly sustained the assessment by the Secretary of the Interior of a 12 1/2 percent royalty on petitioner's gross proceeds, including tax reimbursement payments, from gas production on federal lands pursuant to mineral leases.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-10a) is reported at 978 F.2d 212. The order of the district court (Pet. App. 11a-12a) adopting the memorandum and recommendation of the magistrate (Pet. App. 13a-23a) is reported at 778 F. Supp. 348. The decision of the Interior Board of Land Appeals (Pet. App. 24a-33a) is reported at 106 I.B.L.A. 394. The decision of the Director of the Minerals Management Service of the Department of the Interior (Pet. App. 44a-50a) is not reported.

JURISDICTION

The judgment of the court of appeals was entered on November 30, 1992. A petition for rehearing was denied on January 27, 1993. Pet. App. 34a-35a. The petition for a writ of certiorari was filed on April 26, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. The Mineral Leasing Act of 1920, 30 U.S.C. 181 *et seq.*, authorizes the Secretary of the Interior to grant leases for the recovery of oil and gas from public lands. Lessees must pay the United States a royalty of 12 1/2 percent "in amount or value of the production removed or sold from the lease." 30 U.S.C. 226(b). The Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. 3301 *et seq.*, establishes price ceilings for the sale of defined categories of natural gas. Under the NGPA, "a price for the first sale of natural gas shall not be considered to exceed the maximum lawful price applicable to the first sale of such natural gas under this part if such first sale price exceeds the maximum lawful price to the extent necessary to recover * * * [s]tate severance taxes attributable to the production of such natural gas and borne by the seller." 15 U.S.C. 3320(a).

Petitioner produces and sells natural gas from federal lands in Utah and Wyoming pursuant to leases granted under the Mineral Leasing Act. Pet. App. 2a. Both States impose a severance tax on the production of gas. See Wyo. Stat. Ann. 39-6-302 (1990 & Supp. 1992); Utah Code Ann. 59-5-102 (1992). Petitioner's contracts with purchasers provide that the gas will be sold at the maximum price permitted by law, including reimbursement for severance taxes pursuant to the NGPA. Pet. App. 16a. Petitioner's leases with the United States provide that the 12 1/2 percent royalty will be "computed in accordance with the Oil and Gas Operating

Regulations" promulgated by the Secretary of the Interior. See *id.* at 4a. As applicable to petitioner, those regulations provide that severance tax reimbursements are included in the total value of production on which the government's royalty is calculated. See *id.* at 8a.

The Secretary's mineral lease program is administered by the Minerals Management Service (MMS) within the Department of the Interior. An MMS audit disclosed that petitioner had not paid royalties on the portion of the total value of production that was attributable to reimbursements for payment of state severance taxes from August 1, 1978, through July 31, 1984. Accordingly, MMS ordered petitioner to pay $1,052,597.41 in additional royalties for August 1, 1978, through December 31, 1983, Pet. App. 51a-56a, and $685,253.50 in interest on that sum, *id.* at 36a-39a. MMS also ordered petitioner to pay royalties on state-tax reimbursements for gas production after 1983. *Id.* at 39a-43a. Petitioner paid the demanded royalties under protest and posted bond for the late payment charges, and then sought administrative review.

2. a. The Director of the MMS denied petitioner's administrative appeal. Pet. App. 44a-50a. He explained that "it has been the consistent position of the Federal lessor that a royalty is due on a reimbursement of State severance tax." *Id.* at 46a. The Director noted that *Hoover & Bracken Energies, Inc.* v. *United States Dep't of the Interior*, 723 F.2d 1488 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984), and *Wheless Drilling Co.*, 13 I.B.L.A. 21 (1973), had established that "a royalty is payable on the value of the production; the amount paid by the purchaser to the producer is a valid measurement of the value; and any payment identified as a reimbursement of State severance tax is a portion of the gross proceeds." Pet. App. 47a. The Director accordingly

affirmed the orders requiring petitioner to pay royalties on severance tax reimbursements.

b. The Interior Board of Land Appeals affirmed. Pet. App. 24a-33a. The Board noted that "[i]t has been well established for many years that severance tax reimbursements made by the buyer of gas produced from Federal wells to the Federal lessee/producer/seller are properly included as part of the gross value of the production in computation of the royalty due to the Government." *Id.* at 27a (citing cases). The value of petitioner's gas production for royalty purposes is determined by what its purchasers are willing to pay for it; the value of gas production for computing the federal royalty therefore includes the tax payments. See *id.* at 30a. Finally, the Board rejected petitioner's claim that including tax reimbursements in the royalty base violated the provisions of the NGPA, explaining that "no language in the Act or its legislative history indicat[es] that Congress intended to change any existing royalty obligations between the lessees and the Government." *Id.* at 32a.

c. Petitioner then brought this suit challenging the Department's decision. The district court adopted, with two minor changes, the magistrate's memorandum and recommendation, and granted the government's motion for summary judgment. Pet. App. 11a-12a. The court recognized that "[e]xisting case law upholds the [Secretary's] practice of assessing royalties on a production value that includes tax reimbursements." *Id.* at 19a, citing *Hoover & Bracken Energies, Inc.*, 52 I.B.L.A. 27 (1981), aff'd, 723 F.2d 1488 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984), and *Wheless Drilling Co.*, *supra*. The court found the gross proceeds approach to be reasonable: "[R]oyalty is assessed on value of production as reflected by the market. In the marketplace, [petitioner] is able to sell its gas for a maximum legal price plus re-

imbursement of the severance tax." Pet. App. 21a. The court also rejected petitioner's contention that enactment of the NGPA affected the government's right to include tax reimbursements in the royalty calculation, because "nowhere in the Act does Congress indicate any concern with royalties." *Id.* at 20a.

d. The court of appeals affirmed. Pet. App. 1a-10a. The court held that "[t]he [Secretary's] longstanding method of including state severance tax reimbursements from purchasers in the calculation of 'gross proceeds' is a 'permissible' interpretation and is supported by case law." *Id.* at 6a, citing *Mesa Operating Ltd. Partnership* v. *U.S. Dep't of the Interior*, 931 F.2d 318 (5th Cir. 1991), cert. denied, 112 S. Ct. 934 (1992); *Hoover & Bracken Energies*, *supra*; *CIG Exploration, Inc.* v. *Lujan*, No. 91-CV-0096-J (D. Wyo. June 26, 1992); and *Wheless Drilling Co.*, *supra*. The court explained that "the [Department of the Interior] has consistently included state severance taxes in calculating gross proceeds for purposes of royalty calculations, and even modified its regulations defining 'gross proceeds' to include tax reimbursements." Pet. App. 8a. Finally, the court held that "[p]assage of the NGPA did not disrupt, and was not intended to disrupt, this long-standing practice." *Id.* at 10a. The court concluded that the Department had "made a reasonable and permissible interpretation of its regulations governing royalties owed on federal natural gas leases, and neither the regulations nor their interpretation exceeded authority granted to it by Congress." *Id.* at 22a.

ARGUMENT

Petitioner renews its contention that, contrary to the longstanding practices reflected in the Secretary's regulations, amounts recovered by federal mineral lessees to reimburse them for payment of state

severance taxes should not be included in the value of production for purposes of computing the royalty due the United States. That argument was correctly rejected by the court of appeals, the district court, the Interior Board of Land Appeals, and the Director of the Minerals Management Service. There is no conflict with any decision of this Court or of any other court of appeals. Accordingly, further review is not warranted.

1. a. Petitioner asserts that the statute "clearly means" (Pet. 11) that the government is entitled to a royalty calculated as the value of 12 1/2 percent of actual production. The flaw in petitioner's argument is its incomplete reading of the Mineral Leasing Act. What the Act actually says is that the government is entitled to a royalty which shall not be less than "12 1/2 per centum in amount or *value of production* removed or sold *from the lease*." 30 U.S.C. 226(b) (emphasis added). The plain meaning of that provision is that where, as here, the Secretary takes royalty in value (as opposed to "in amount," *i.e.*, in kind), the royalty owed is 12 1/2 percent of the value of all production "from the lease," not the value of an artificially segregated 12 1/2 percent of the lease production. A common-sense method of valuing that production is by reference to the amount the lessee received for the gas, which reflects the total amount purchasers were willing to pay for the gas. That amount includes the portion attributable to reimbursement of the lessee's costs associated with paying state taxes. In other words, the "value of production * * * from the lease" is the price of all the gas produced under it, and the government is entitled to 12 1/2 percent of that amount. "[W]here, as here, the statute's language is plain, 'the sole function of the courts is to enforce it according to its terms.'" *United States* v. *Ron Pair Enterprises, Inc.*, 489 U.S. 235, 241 (1989) (quoting *Caminetti* v. *United States*, 242 U.S. 470, 485 (1917)); see

also, *e.g.*, *INS* v. *Cardoza-Fonseca*, 480 U.S. 421, 447-448 (1987).

b. To the extent there is any ambiguity in the Mineral Leasing Act, it is resolved by Department of the Interior regulations. See Pet. App. 26a (Mineral Leasing Act "reserves to the Department the authority and responsibility to establish reasonable value for royalty purposes"). For more than 50 years, the Secretary has interpreted the Act to mean that the government is entitled to 12 1/2 percent of the lessee's gross proceeds from the sale of the gas produced under the lease. See 1 Fed. Reg. 2000 (1936) ("under no conditions shall the value of any of said substances for the purpose of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof"). The regulations applicable to petitioner provide that "[t]he royalty on gas shall be the percentage established by the terms of the lease"—here, 12 1/2 percent—"of the value or amount of the gas produced," 30 C.F.R. 206.105 (1987), and that "[u]nder no circumstances shall the value of production * * * for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof," 30 C.F.R. 206.103 (1987). The Secretary's regulations further specify that "[g]ross proceeds include, but are not limited to, tax reimbursements." Notice to Lessees and Operators of Federal and Indian Onshore Oil and Gas Leases (NTL-5), 42 Fed. Reg. 22,610, 22,611 (1977); Notice to Lessees and Operators of Federal Onshore Oil and Gas Leases (NTL-1), 42 Fed. Reg. 4547, 4548 (1977).[1]

[1] NTL-1 and NTL-5, along with the "gross proceeds" rule in 30 C.F.R. 206.103, remained in effect until 1988, when Congress enacted the Notice to Lessees Numbered 5 Gas Royalty Act of 1987, Pub. L. No. 100-234. Congress recognized that "NTL-5 was a duly promulgated rule of the Department of the Interior," 101 Stat. 1719, and modified the method of royalty calculation to account for

The court of appeals properly deferred to the Secretary's regulations interpreting the statute he is charged with administering, *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843 (1984), and to the Secretary's interpretation of those regulations, *Martin* v. *OSHRC*, 111 S. Ct. 1171, 1175-1176 (1991).

2. Petitioner claims that the government is entitled only to the value of a "royalty share" equal to 12 1/2 percent of actual production. See Pet. 5, 11. As the court of appeals correctly noted, petitioner's argument "rests on a false distinction between 'government royalty share' and 'working interest share.'" Pet. App. 8a n.5. That distinction appears nowhere in the Mineral Leasing Act, the Secretary's implementing regulations, or petitioner's leases with the government, and petitioner's attempts to support the distinction by reference to state law, federal common law, and decisions of this Court are unavailing.

a. Petitioner improperly attempts to import concepts used for state taxation purposes into the rules governing federal royalties on gas production under federal leases. See Pet. 13-16. The States do recognize different ownership interests in gas production, distinguishing between a "working interest owner" and a "royalty interest owner," see, *e.g.*, Utah Code Ann. 59-5-101(12) and (19) (1992), and the States apply that distinction in de-

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gas sales at prices below the ceiling prices set by the NGPA. Congress expressly provided in that Act that "[u]nder no circumstances shall the value of production * * * for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee." 101 Stat. 1720. The Department issued comprehensive new royalty valuation regulations, see 53 Fed. Reg. 1272 (1988), which continue the express requirement that tax reimbursements are included in the royalty calculation. See 30 C.F.R. 206.151, 206.152(h), 206.153(h) (1988).

termining the obligation to pay taxes on production. Thus, for state taxation purposes, each interest owner is obligated to pay taxes according to its proportionate ownership interest, which is calculated by artificially dividing the gas production into corresponding production shares. However, the States do not tax property owned by the state or federal governments, and the States do not tax all production where a state or federal government is the royalty interest owner under a state or federal lease. Rather, tax is owed only for the production corresponding to the working interest—in petitioner's case, 87 1/2 percent of the production.

The fact that States may recognize different ownership interests in calculating state tax obligations has no relevance, however, to federal royalty valuation.[2] Although only 87 1/2 percent of the production from petitioner's federal leases is subject to state tax, that means only that petitioner is not obligated to pay state severance taxes on 100 percent of its production from those leases. Purchasers, in turn, reimburse petitioner only for the severance taxes it does pay. But this rule has no bearing on the Secretary's authority to determine the value of federal lease production for royalty purposes under the Mineral Leasing Act. See *Wallis* v. *Pan American Petroleum Corp.*, 384 U.S. 63, 69 & n.6 (1966) (royalty payments governed by federal law). The Department of the Interior has determined that such value will be represented, at a minimum, by the lessee's gross receipts from the sale of production, and that gross proceeds include the portion attributable to the purchaser's

[2] Indeed, while the States may differentiate ownership interests for purposes of *taxation*, they do not make such a differentiation for purposes of calculating *royalties* on state mineral leases. See, *e.g.*, *Cities Service Oil & Gas Corp.* v. *Wyoming*, 838 P.2d 146, 152-155 (Wyo. 1992) (rejecting argument similar to that advanced by petitioner in context of state royalty calculation).

reimbursement of the lessee for state taxes. How the underlying tax is calculated in the first instance is irrelevant.[3]

b. Petitioner is also mistaken in asserting that its position is supported by "a body of federal common law." Pet. 12. The Department's longstanding interpretation has been sustained, and petitioner's contrary view has been rejected, by every federal judicial and administrative tribunal presented with the question, both before and after the royalty valuation regulations were supplemented in 1977 by NTL-5 and NTL-1 to make explicit that a lessee's "gross proceeds" from the sale of leasehold production includes tax reimbursements received by the lessee from gas purchasers. See *Mesa Operating Ltd. Partnership* v. *U.S. Dep't of the Interior*, 931 F.2d 318 (5th Cir. 1991), cert. denied, 112 S. Ct. 934 (1992); *Hoover & Bracken Energies, Inc.* v. *United States Dep't of the Interior*, 723 F.2d 1488 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984); *Wheless Drilling Co.*, 13 I.B.L.A. 21 (1973); see also *Marathon Oil Co.* v. *United States*, 604 F. Supp. 1375 (D. Alaska 1985), aff'd, 807 F.2d 759 (9th Cir. 1986), cert. denied, 480 U.S. 940 (1987); *Pennzoil Exploration & Production Co.* v. *Lujan*, 751 F. Supp. 602 (E.D. La. 1990), aff'd, 928 F.2d 1139 (Temp. Emer. Ct. App. 1991); *FMP Operating Co.*, 121 I.B.L.A. 328, 332 (1991); *Miami Oil Producers, Inc.*, 116 I.B.L.A. 345, 347 (1990); *Tricentrol United States, Inc.*, 105 I.B.L.A. 392, 395 (1988); *Amoco Production Co.*, 29 I.B.L.A. 234, 238 (1977); *Kerr-McGee Oil Industries, Inc.*, 70 Interior Dec. 464 (1963).

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[3] Contrary to petitioner's suggestion, this case is not a proper vehicle for the Court to "re-examine the applicability of the doctrine of sovereign immunity as it applies to state taxation of oil and gas produced from public lands." Pet. 18. This case concerns royalty obligations under federal leases, not state taxation of production from federal lands.

c. Finally, petitioner errs in relying on this Court's reference to "the Indian's share of production" in *Oklahoma Tax Commission* v. *Texas Co.*, 336 U.S. 342, 353 (1949), for the proposition that "this Court's prior decisions dealing with the issue of sovereign immunity acknowledge the distinction between Enron's working interest and [the government's] royalty interest." Pet. 16. That case, like the other case cited by petitioner, *Carpenter* v. *Shaw*, 280 U.S. 363 (1930), involved questions of state taxation, not questions of federal royalty valuation under the Mineral Leasing Act. The phrase "Indian's share of production" was dictum used in describing what the case did *not* involve; it does not represent any "acknowledge[ment]" that the Court has recognized a "distinction between Enron's working interest and [the government's] royalty interest" for federal royalty purposes.[4]

[4] *Amici* Mountain States Legal Foundation et al. contend (Br. 6-14) that the Secretary's rule conflicts with the NGPA. Although petitioner made that argument below, it does not rely on that argument in this Court. In any event, the court of appeals correctly held that the NGPA does not circumscribe the Secretary's authority in making royalty calculations. Pet. App. 9a-10a; see also *Mesa Operating*, 931 F.2d at 326.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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